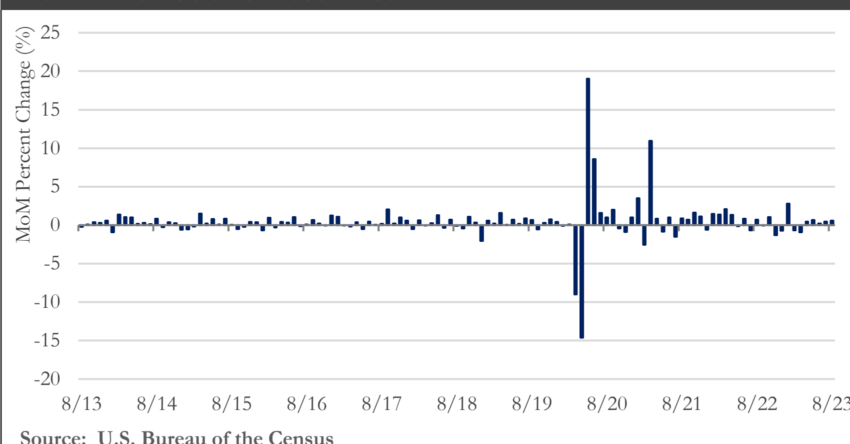
Economic Commentary & Capital Market Update

Recap

This summer's combination of easing inflation and cooling the labor market has fueled optimism that the U.S. could be on the cusp of achieving a soft landing, in which interest-rate increases corralled inflation without causing a recession. But soft landings are considered rare because they are tricky to pull off. The goal would face four threats: the Fed holds lengthy high rates, economic growth accelerates, energy prices rise, or a financial crisis erupts.

Real GDP grew at an annualized rate of 2.1 percent in Q2-2023 due to solid growth in consumer spending and business fixed investment spending. Available data from July and August suggested that real GDP continued to expand in the third quarter.

Solid retail sales—a measure of spending at stores, online, and in restaurants—have contributed to a broad consumer spending surge fueling resilient U.S. economic activity. Job and wage growth remained solid, with people seeking work and earning money. The economy has been on track to expand at around 4.0% annually in the third quarter. With unemployment low, real wages growing, and household net worth hitting another record, American households and consumers should be in a good position. Consumer spending should be close to 4% in the third quarter.



Inflationary pressure has eased. The labor market has also become less tight. But some cracks in the economy have started to appear. Households have lowered savings rates and relied on credit card debt to finance strong growth in consumption expenditures. Delinquencies on mortgages, auto loans, and credit cards have recently increased.

New York (HQ)
400 Park Avenue 6th Floor
New York, NY 10022

Chicago
500 West Madison Street,
Suite 1000
Chicago, IL 60661

Los Angeles
10250 Constellation Blvd
Los Angeles, CA 90067

Newport Beach
4041 MacArthur Blvd
Suite 400
Newport Beach, CA 92660

212.254.4876
info@matrixpcg.com
matrixpcg.com

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No recession?

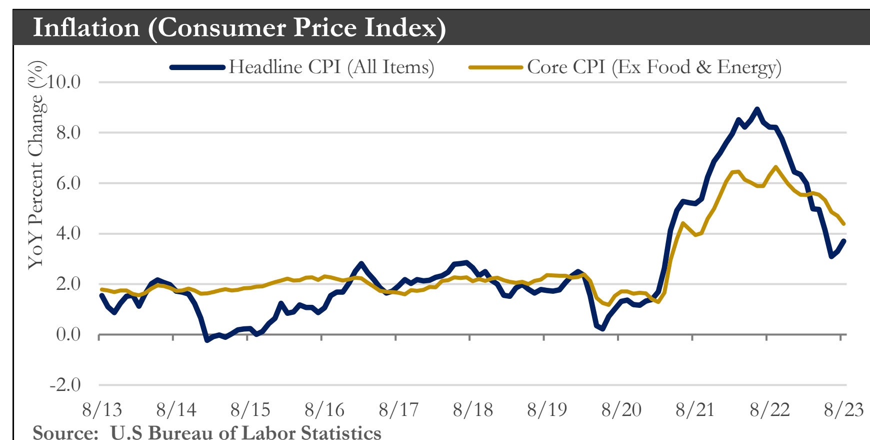
There have been increasing hopes that the United States could avoid recession. Three factors seem to explain why the U.S. economy keeps defying predictions of recession. First, a growing workforce and slower price increases have boosted Americans' inflation-adjusted incomes this year, fueling more hiring and spending. Second, the unusual nature of the COVID-19 pandemic has distorted spending patterns, leading to shortages of goods, housing, and workers. These conditions created enormous pent-up demand that has been less sensitive, for now, to higher rates.

Third, the government showered the economy with cash and held interest rates at rock-bottom levels, allowing businesses and consumers to lock in lower borrowing costs. Subsequent legislation, including the Inflation Reduction Act and the $53 billion Chips and Science Act, further boosted federal spending, and spurred additional private-sector investment in manufacturing.

None of this would imply the economy will be resilient forever. The Fed raised its benchmark federal funds rate to a 22-year high in July, and officials have kept the door open to further hikes if economic activity should accelerate.

Inflation

The Consumer Price Index ("CPI") rose 0.6% month-on-month between July and August. On a 12-month basis, CPI inched 0.4% higher to 3.7% in August. Energy prices significantly drove August's acceleration, rising the fastest since June 2022. Core inflation rose by 0.3% in the past month – accelerating from June and July's monthly gains of 0.2%. The 12-month change on core continued to edge lower, falling 0.3% to 4.4%.



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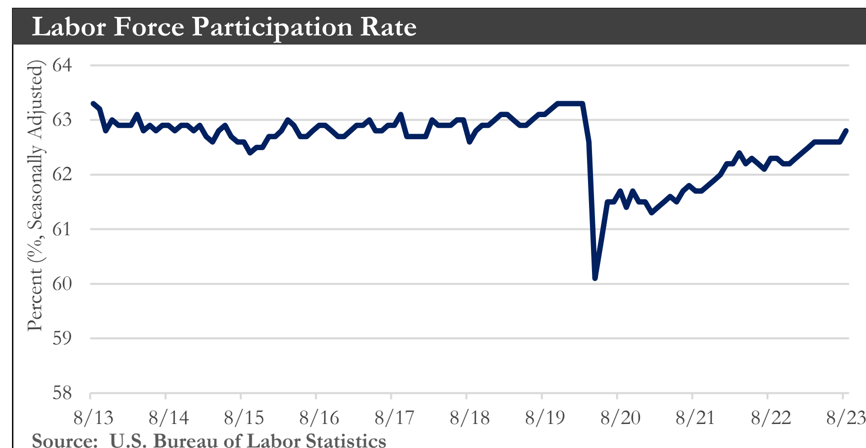
Inflation is expected to trend lower. Smoother functioning supply chains and higher financing costs for big-ticket items like vehicles have reversed the rapid run-up in goods prices over the past three years. The recent moderation in monthly shelter readings has also ensured that official measures of housing inflation will follow private market measures of rent growth and slow sharply through the middle of next year.

Labor Market

Slower summer hiring and the August unemployment rate have shown the labor market is moderating amid high interest rates. U.S. employers added 187,000 jobs last month, while payrolls in June and July were revised down a combined 110,000. Over the past three months, 150,000 jobs were added monthly, down from 238,000 in March through May. Hiring has slowed as job openings have fallen to a 28-month low.

The unemployment rate rose to 3.8% - the highest level in 18 months. The participation rate rose 0.2% to a new cyclical high of 62.8%.



Housing Market

The housing market has remained under pressure amid elevated mortgage rates and high prices. Single-family construction has continued to be propelled by buyers who have become disenchanted with the resale market, where inventory is low, and prices are high. By contrast, a more challenging lending environment and robust incoming apartment supply pipeline would encourage multifamily developers to move forward with new projects. The divergence between solid single-family construction and lagging multifamily is likely continue.

New York (HQ)
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New York, NY 10022

Chicago
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Suite 1000
Chicago, IL 60661

Los Angeles
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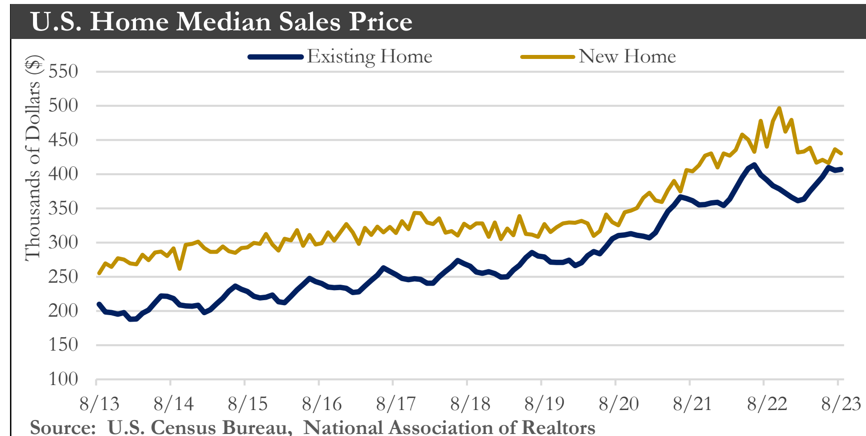

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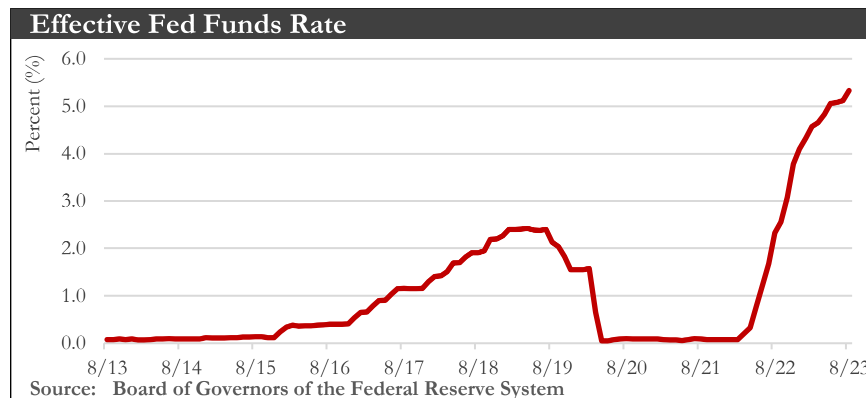
With mortgage rates increasing, it is no wonder that home sales activity has remained near multi-decade lows. The elevated rate environment has not just held back would-be buyers; it has also posed a hurdle on the supply side, as existing homeowners with much lower mortgage rates have become reluctant to move. The tightness in the resale market has kept a floor on home prices while also pushing more would-be buyers to the "new" home market.

Monetary Policy

At the September meeting, the Federal Reserve Open Market Committee ("FOMC") maintained the federal funds rate in the 5.25% to 5.50% range and announced a continuation of its balance sheet runoff.



The Fed has now forecast the closest thing to a perfect landing for the economy: real GDP growth would barely move below its trend pace in 2024, while the unemployment rate would effectively land right on its steady-state level, and inflation would grind back to target. At the same time, Fed members have maintained that one more hike is on the table for 2023 while reducing the number of expected rate cuts in 2024.

The September meeting highlighted the 'higher for longer' rhetoric that the Fed has reinforced over recent meetings. This has helped to maintain tight financing conditions, a prerequisite for the economy to slow sufficiently while easing price pressures. Fed projections showed the federal funds rate will be lowered to around 5% by the end of 2024, implying two rate cuts next year if the central bank increases them again this year.

Outlook

There are increasing hopes that the United States can avoid a recession. The U.S. economy has shown remarkable resilience, including GDP growth of 2.1% quarter-over-quarter annualized during Q2. While softer readings from the ISM manufacturing and services indices portend slower growth ahead, trends in labor markets and consumer spending have remained reasonably encouraging. Finally, while inflation has remained above the Federal Reserve's target for now, enough progress has been made that the peak in the federal funds rate has likely already been reached. Stemming from these trends of ongoing employment growth and receding inflation are important shifts in real household income trends that could be significant for consumer spending and, thus, the overall economy. As paychecks have continued to increase and cost-of-living pressures have diminished, growth in household disposable income has started to outpace growth in consumer spending.

However, while that does offer encouragement for a "soft landing," developments could still unsettle the U.S. economy. With excess savings from the pandemic having been substantially worked through and households perhaps less willing or unable to take on further consumer credit, some factors supporting consumer spending would be less helpful moving forward. More broadly, regional banking sector strains could contribute to reduced lending, the housing sector would face some headwinds, and declining corporate profits could restrain business investment. Finally, the increase could restrain the economy even if interest rates do not rise further. That is especially the case should the Fed maintain its policy rate at an elevated level for an extended time, even as inflation recedes further. A "higher for longer" stance from the Fed could increase real interest rates that would restrain household and business spending.

Overall, there are no clear signals of further rate hikes, but at the same time, it appears the Fed will keep policy interest rates elevated for an

New York (HQ)
400 Park Avenue 6th Floor
New York, NY 10022

Chicago
500 W. Madison Street,
Suite 1000
Chicago, IL 60661

Los Angeles
10250 Constellation Blvd.
Los Angeles, CA 90067

Newport Beach
4041 MacArthur Blvd
Suite 400
Newport Beach, CA 92660

212.254.4876
info@matrixpcg.com
matrixpcg.com

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extended period. Given that restrictive monetary policy would remain in place for some time, there is still a possibility of U.S. economic recession. That said, the likelihood of recession is getting lower, and the potential economic downturn is getting milder.

Capital Markets Commentary: Recap

With a few exceptions, September and the third quarter saw the global equity markets give back some of the gains earned in the first half of 2023. Bond markets, too, delivered red ink for the quarter except for short-term fixed-income instruments. Markets were responding to the rise in the yield curve and the commitment on the part of the Fed to stay the course, holding interest rates higher for longer. Longer bond maturities were especially hard hit as rates on government bonds maturing in 10 years or more climbed to about 4.7%. By the quarter's end, the grip of tighter financial conditions showed up in sentiment and consumer behavior.

U.S. stocks across the capitalization and style spectrum delivered modest declines in the third quarter. Small-cap and mid-cap stocks lost more ground than larger company stocks. The S&P 500 was down 3.3%, the Russell Mid Cap Index was down 4.7%, and the index of smaller companies, the Russell 2000, was down 5.1%.

There was a modest reversal of fortunes when comparing Value and Growth style stocks. Unlike earlier in the year, Value stocks lost less ground than Growth stocks in the third quarter. This was a small pullback from some of the extreme valuations given to Growth stocks earlier in the year driven by investor enthusiasm over all thing's artificial intelligence.

International equities also lost ground in the third quarter. The MSCI All Country World Index ex-U.S. was down 3.8%. There were a couple of notable exceptions, with Indian stocks gaining ground up 2.7% for the quarter and companies in so-called Frontier Markets that were up about 2.0%.

Bond prices across the globe also took a hit from rising interest rates and the prospects of rates being held higher for longer by central banks. With a few notable exceptions, bonds delivered negative returns. The broad Bloomberg Aggregate Bond Index was down 3.2%, the Bloomberg Global Aggregate ex-U.S. was down 4.0%, Short-term Treasury bills were up 1.3%, and even U.S. corporate high-yield bonds were up fractionally.

New York (HQ)
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Chicago
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Suite 1000
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Los Angeles
10250 Constellation Blvd
Los Angeles, CA 90067

Newport Beach
4041 MacArthur Blvd
Suite 400
Newport Beach, CA 92660

212.254.4876
info@matrixpcg.com
matrixpcg.com

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Capital Markets Commentary: Outlook

The outlook for stock returns remains uncertain given the slowly deteriorating dynamics of the economy, higher interest rates that are likely to stay at these levels or higher longer than expected, and the negative impact this should have on demand for goods and services in the economy. Downstream, this should continue to impact corporate profits, which have been growing more slowly in the past year. The U.S. is expected to head into a period of slower economic growth, if not a mild recession. That recession will likely result in higher unemployment. The equity markets earlier in the year seem to have been looking past this well-telegraphed slowdown to a period of falling interest rates. But some stock prices, especially those driven by more speculative impulses, may have to adjust to the realities of a less constructive longer-term economic outlook.

However, the longer-term outlook for bonds appears to look pretty bright, mainly due to the likelihood that the Fed is closer to the end of its rate hiking cycle, inflation is coming down, and now bonds offer a respectable coupon rate after years of ultra-low interest rates. Bond coupon rates currently provide real competition for investment dollars versus stocks, given the more expensive investment profile of stocks in general.

There continue to be downside risks to the capital markets, which should be kept in mind as 2023 comes to an end. Those risks include another Congressional budget impasse in November, the Fed possibly overshooting their rate increases, a deeper-than-expected recession occurring, more stress in the banking system emerging due to the industry's deposit level declines, an increase in credit defaults and household bankruptcies as the economy slows, a possible escalation of the conflict in Ukraine with its potential impact on the prices of oil and commodities, and of course, other unexpected geopolitical events.

A longer-term view of markets suggests that the tailwinds stock and bond investors enjoyed in recent years, including massive fiscal stimulus and declining and ultra-low interest rates, will not resurface soon to smooth over inevitable hard times. Securities' values are more likely to be driven by the organic operational successes of businesses rather than help from the federal government. These conditions should favor astute stock and bond selection.

Sources: Department of Labor, Department of Commerce, Institute for Supply Management, Bloomberg, the Federal Reserve Bank, European Central Bank

New York (HQ)
400 Park Avenue 6th Floor
New York, NY 10022

Chicago
500 W. Madison Street,
Suite 1000
Chicago, IL 60661

Los Angeles
10250 Constellation Blvd
Los Angeles, CA 90067

Newport Beach
4041 MacArthur Blvd
Suite 400
Newport Beach, CA 92660

212.254.4876
info@matrixpcg.com
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New York (HQ)
400 Park Avenue 6th Floor
New York, NY 10022

Chicago
500 W. Madison Street,
Suite 1000
Chicago, IL 60661

Los Angeles
10250 Constellation Blvd
Los Angeles, CA 90067

Newport Beach
4041 MacArthur Blvd
Suite 400
Newport Beach, CA 92660

212.254.4876
info@matrixpcg.com
matrixpcg.com

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Index Performance as of: 9/30/2023

	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Russell							
Russell 3000 Value	-3.94	-3.15	1.64	14.01	11.16	5.95	8.26
Russell 3000	-4.76	-3.25	12.38	20.43	9.36	9.12	11.26
Russell 3000 Growth	-5.50	-3.34	23.77	26.62	7.54	11.69	13.93
Russell 1000 Value	-3.86	-3.17	1.77	14.40	11.02	6.20	8.43
Russell 1000	-4.70	-3.15	13.00	21.17	9.51	9.61	11.61
Russell 1000 Growth	-5.44	-3.13	24.97	27.71	7.97	12.41	14.47
Russell Midcap Value	-5.09	-4.46	0.52	11.01	10.95	5.15	7.89
Russell Midcap	-5.02	-4.68	3.89	13.42	8.07	6.36	8.97
Russell Midcap Growth	-4.87	-5.22	9.88	17.46	2.61	6.97	9.94
Russell 2000 Value	-5.21	-2.97	-0.58	7.76	13.27	2.55	6.16
Russell 2000	-5.89	-5.14	2.51	8.87	7.13	2.36	6.62
Russell 2000 Growth	-6.60	-7.32	5.23	9.55	1.06	1.53	6.69
Standard & Poors							
S&P 500	-4.77	-3.27	13.06	21.59	10.13	9.89	11.89
Consumer Discretionary	-5.98	-4.80	26.58	13.69	2.33	7.17	11.51
Consumer Staples	-4.53	-5.97	-4.76	7.35	6.09	8.50	8.85
Energy Sector	2.63	12.22	5.99	30.09	51.23	8.87	5.03
Financials Sector	-3.14	-1.13	-1.65	11.68	13.48	5.98	9.63
Health Care Sector	-2.96	-2.65	-4.09	8.18	8.61	8.21	11.73
Industrials Sector	-5.96	-5.16	4.50	24.54	11.41	7.26	10.02
Information Technology	-6.87	-5.64	34.72	41.10	13.31	18.38	20.36
Materials Sector	-4.78	-4.76	2.61	18.05	9.46	8.60	8.69
Real Estate Sector	-7.25	-8.90	-5.51	-1.90	2.26	4.34	5.96
Communication Services	-3.26	3.07	40.43	38.48	5.31	7.88	7.26
Utilities Sector	-5.63	-9.25	-14.41	-7.02	2.92	5.66	8.32
Other U.S. Equity							
Dow Jones Industrial Avg.	-3.42	-2.10	2.73	19.18	8.62	7.13	10.78
NASDAQ 100 Stock	-5.02	-2.86	35.37	35.31	9.69	15.05	17.62
International Equity - Broad Market							
MSCI EAFE NR	-3.42	-4.11	7.08	25.65	5.75	3.24	3.82
MSCI Emerging Mkts NR	-2.62	-2.93	1.82	11.70	-1.73	0.55	2.07
MSCI Frontier Markets NR	-3.79	1.98	7.37	6.48	1.74	1.63	2.25
MSCI ACWI NR	-4.14	-3.40	10.06	20.80	6.89	6.46	7.55
MSCI ACWI ex USA NR	-3.16	-3.77	5.34	20.39	3.74	2.58	3.35
MSCI AC Asia ex Japan NR	-2.68	-3.34	-0.42	10.88	-3.31	0.56	3.55
International Equity - Country Region							
MSCI Brazil NR	0.21	-3.63	12.60	15.25	13.30	4.25	0.59
MSCI BRIC NR	-1.12	-0.76	-1.13	7.67	-7.25	-1.08	1.64
MSCI China NR	-2.75	-1.94	-7.29	5.24	-14.27	-4.16	1.67
MSCI Europe NR	-1.56	-2.06	8.83	19.22	10.95	5.90	6.41
MSCI India NR	1.67	2.72	7.96	10.10	14.94	9.83	9.75
MSCI Japan NR	-2.10	-1.59	11.21	25.92	2.81	2.06	4.38
MSCI EM Latin Amer NR	-2.30	-4.75	12.89	19.37	15.07	2.81	0.24
Fixed Income							
Bloomberg US Agg TR	-2.54	-3.23	-1.21	0.64	-5.21	0.10	1.13
Bloomberg U.S. T-Bills	0.45	1.34	3.70	4.62	1.75	1.71	1.09
Bloomberg US Govt	-2.17	-2.99	-1.45	-0.74	-5.73	-0.03	0.65
Bloomberg US Credit	-2.60	-3.01	0.03	3.46	-4.83	0.86	2.12
Bloomberg US Corp HY	-1.18	0.46	5.86	10.28	1.76	2.96	4.24
Bloomberg Municipal	-2.93	-3.95	-1.38	2.66	-2.30	1.05	2.29
Bloomberg US TIPS	-1.85	-2.60	-0.78	1.25	-1.98	2.12	1.74
Bloomberg Global-Agg	-2.92	-3.59	-2.21	2.24	-6.93	-1.62	-0.44
Bloomberg Gbl Agg ex-USD	-3.30	-4.00	-3.20	3.39	-8.39	-3.10	-1.73
Bloomberg EM USD Agg	-2.28	-2.31	0.91	7.56	-4.21	0.23	2.35
Alternative Investments							
Alerian MLP	3.24	9.84	20.33	32.40	42.72	6.61	1.84
Bloomberg Commodity	-0.69	4.71	-3.44	-1.30	16.23	6.13	-0.75
FTSE Nareit Equity REITs	-6.80	-7.13	-2.14	2.99	5.76	2.77	5.96
S&P Global Nat Res	-0.35	3.70	0.47	17.78	19.16	6.38	5.24
S&P N.Amer Nat Res	0.09	8.06	4.90	24.05	32.78	7.49	3.50

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